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SUBJECT: GERMAN TAX CUTS AND BUDGET DEFICIT: THE LAST HURRAH

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¶1. (SBU) SUMMARY: The German budget deficit looks set to reach 6 percent of GDP in 2010, thanks to a drop off in tax revenues, to a spike in crisis-related spending, and now, to the first tranche of tax cuts fulfilling the new coalition government,s pre-election campaign promises. EU and constitutional requirements, however, will force the government to start implementing its fiscal "exit strategy" in the near future. Officials seem to be pinning their hopes on the idea that economic growth resulting from the new stimulus will generate higher tax revenues, eventually leading to lower deficits. Yet the flood of red ink may make it difficult for Merkel's government to push through the second phase of its tax cuts next year as planned. In fiscally conservative Germany, running budget deficits is never a crowd pleaser, regardless of economic conditions.
END SUMMARY.

MAKING HISTORY

¶2. (SBU) On December 17, 2009 Chancellor Merkel's cabinet approved a 325 billion euro budget for FY 2010 that marks Germany's highest postwar federal deficit. Officially totaling 85.8 billion euros)- almost double the 2009 deficit -- the actual shortfall will be more like 100 billion euros once bank bailout and stimulus measures are factored in. Moreover, the EU Growth and Stability Pact, which limits member states to deficits of no more than 3 percent of gross domestic product (GDP), takes into account state and local deficits. Through this lens, Germany could be looking at a consolidated deficit of around 144 billion euros in FY 2010, or 6 percent of GDP.

¶3. (SBU) According to Finance Ministry officials, around half of Germany's budget shortfall is attributable to the steep drop off in tax revenues. (REFTEL) Much of the extra spending is earmarked for the Labor Ministry. The falling number of full-time employed and the costs of government-sponsored schemes, such as the "short-shift" ("Kurzarbeit") program, eat into the budget of the National Employment Agency, which is to receive 16 billion euros. While military spending will dip by 0.1 percent, expenditures

for foreign and development assistance are to increase by 6.5 percent. The federal government will provide health insurance companies with an additional 7.5 billion euros of assistance and the pension funds with 80 billion euros. Debt service has become the fourth biggest line item in the budget with almost 11 billion euros. As a result of the FY 2010 budget, Germany's national debt will rise from 73 percent to 78 percent of GDP next year.

NOT SO FAST

¶4. (SBU) Germany is one of 14 member states currently subject to EU excessive debt procedures; it has until 2013 to get its deficit below 3 percent of GDP. Finance Minister Wolfgang Schaeuble has vowed tough austerity measures in order to comply. Further down the road, Germany faces an additional, self-imposed restriction, known as the "debt brake." This constitutional balanced budget amendment requires Germany's structural deficit to fall to no more than 0.35 percent of GDP by 2016. Thomas Szewczyk, head of the Bundesbank's Berlin office, told us the government would need to start reducing its deficit in 2011 by around 10 billion euros a year every year until 2016. Despite the potential countercyclical effects of fiscal consolidation, the Bundesbank sees Germany's "debt brake" as an important part of its "exit strategy" from extraordinary measures taken to combat the economic crisis. Many ordinary Germans are wary of the inflationary consequences of debt, and also support the amendment's aims.

FULFILLING CAMPAIGN PLEDGES

¶5. (SBU) Despite the record deficit, Merkel's Christian Democratic Union (CDU)/Christian Social Union (CSU)-Free Democratic Party (FDP) coalition pushed through on December 18 a controversial new stimulus plan or "growth acceleration law" worth 8.5 billion euros. A second installment worth 19 billion euros is envisaged for the FY 2011 budget. The first phase includes additional family allowances and a drop in the value-added tax (VAT) on hotels and restaurants. The cuts ran into stiff opposition from federal states, particularly structurally weak Schleswig-Holstein and Saxony, which feared a loss of state tax revenue. Only after the federal government gave assurances of additional money for education and the like in coming years did enough states relent for the bill to pass. Several states led by Social Democratic Party (SPD) governments, however, are threatening to challenge the constitutionality of the new measure in court.

¶6. (SBU) When asked how the government squares the tax cuts with mounting fiscal pressures, Andreas Nicolin, an economic advisor at the Chancellery, explained that stronger growth resulting from the measures should generate higher tax revenues and help balance the budget. Leading German economists have sharply criticized the plan, however, saying the cuts will actually do little to boost growth, while exacerbating the dire fiscal situation.

COMMENT

¶7. (SBU) While next year's deficit is clearly of historic proportions, Germany's fiscal outlook is not in especially bad shape compared with several other EU member states. Still, EU and constitutional restraints mean the government will have to start trimming as soon as possible. Merkel's coalition pushed through the first installment of tax cuts mainly out of an obligation to follow through on a campaign pledge to cut taxes. Finance Minister Schaeuble and others recognize that fiscal consolidation has to start in earnest with the FY 2011 budget, however, so the second installment of tax cuts worth 19 billion euros could be a difficult sell.

As defenders of the EU Growth and Stability Pact, Germany also wishes to set a good example for laggards such as Greece and Spain, according to Finance Ministry contacts. Even if the economic situation worsens, it could be politically more popular to cut the deficit than to stimulate the economy with further deficits. For his part, Schaeuble has already begun laying the rhetorical groundwork for the coming fiscal consolidation, pledging to do whatever was necessary to get the German house in order.

MURPHY